Effective Date: January 6, 1997

COORDINATED ISSUE
LIFE INSURANCE INDUSTRY
IRC SECTION 807 BASIS ADJUSTMENT
CHANGE IN BASIS v. CORRECTION OF ERROR

ISSUE:

Whether a change in determining any of the reserve items referenced in IRC section 807(c) as of the close of a post-1983 taxable year must be treated as a change in basis adjustment under section 807(f), which requires the change to be amortized over a 10-year period starting with the subsequent taxable year; or, whether the change must be treated as a correction of an error and, therefore, taken into account in full in the year of the change?

LAW:

IRC section 807 provides general rules for the treatment of certain reserves.

Subsections 807(a) and (b) provide for the treatment of differences between the closing and opening balances of reserve items described in subsection 807(c).

Subsection 807(c) describes the reserve items governed by section 807; the statute provides as follows:

> (c) ITEMS TAKEN INTO ACCOUNT.- The items referred to in subsections (a) and (b) are as follows:
>
> (1) The life insurance reserves (as defined in section 816(b)).
>
> (2) The unearned premiums and unpaid losses included in total reserves under section 816(c)(2).
>
> (3) The amounts (discounted at the appropriate rate of interest) necessary to satisfy the obligations under insurance and annuity contracts, but only if such obligations do not involve (at the time with respect to which the computation is made under this paragraph) life, accident, or health contingencies.
>
> (4) Dividend accumulations, and other amounts, held at interest in connection with insurance and annuity contracts.

(5) Premiums received in advance, and liabilities for premium deposit funds.

(6) Reasonable special contingency reserves under contracts of group term life insurance or group accident and health insurance which are established and maintained for the provision of insurance on retired lives, for premium stabilization, or for a combination thereof.

For purposes of paragraph (3), the appropriate rate of interest for any obligation is whichever of the following rates is the highest as of the time such obligation first did not involve life, accident, or health contingencies: the applicable Federal interest rate under subsection (d)(2)(B)(i), the prevailing State assumed interest rate under subsection (d)(2)(B)(ii), or the rate of interest assumed by the company in determining the guaranteed benefit. In no case shall the amount determined under paragraph (3) for any contract be less than the net surrender value of such contract. For purposes of paragraph (2) and section 805(a)(1), the amount of the unpaid losses (other than losses on life insurance contracts) shall be the amount of the discounted unpaid losses as defined in section 846.

Methods of computing the life insurance reserves designated under subsection 807(c)(1) are described under subsection 807(d); and other special rules for computing reserves under section 807 are provided under subsection 807(e).

Subsection 807(f) provides rules of adjustment when there has been any change in the basis of computing any of the reserve items referred to in subsection 807(c) from the end of one taxable year to the end of the next taxable year. The statute provides as follows:

(f) ADJUSTMENT FOR CHANGE IN COMPUTING RESERVES.

(1) 10-YEAR SPREAD.-

(A) IN GENERAL.- For purposes of this part, if the basis for determining any item referred to in subsection (c) as of the close of any taxable year differs from the basis for such determination as of the close of the preceding taxable year, then so much of the difference between -

(i) the amount of the item at the close of the taxable year, computed on the new basis, and

(ii) the amount of the item at the close of the taxable year, computed on the old basis, as is attributable to contracts issued before the taxable year shall be taken into account under the method provided in subparagraph (B).

(B) METHOD. - The method provided in this subparagraph is as follows:

(i) if the amount determined under subparagraph (A)(i) exceeds the amount determined under subparagraph (A)(ii), 1/10 of such excess shall be taken into account, for each of the succeeding 10 taxable years, as a deduction under section 805(a)(2); or

(ii) if the amount determined under subparagraph (A)(ii) exceeds the amount determined under subparagraph (A)(i), 1/10 of such excess shall be included in gross income, for each of the 10 succeeding taxable years, under section 803(a)(2).

(2) TERMINATION AS LIFE INSURANCE COMPANY. - Except as provided in section 381(c)(22) (relating to carryovers in certain corporate readjustments), if for any taxable year the taxpayer is not a life insurance company, the balance of any adjustments under this subsection shall be taken into account for the preceding taxable year.

AUDIT ANALYSIS:

FACTS: An examining agent proposes to adjust IRC section 807(c) reserve amount(s) because the reserve amount(s) fail to meet the specific requirements set forth in IRC section 807(d) and/or section 807(e).

The taxable year under audit is 1986. According to the taxpayer, the opening balance reserve amount for 100 contracts issued prior to 1986 is $1,000,000. These contracts ("old contracts") have a closing balance reserve amount equal to $2,100,000. During 1986 the taxpayer issued 50 new contracts ("new contracts"), and these new contracts have a closing balance reserve amount equal to $900,000. According to the taxpayer, therefore, the total closing balance reserve amount for all the contracts is $3,000,000, summarized as follows:

Reserve Balances as Filed by Taxpayer

	"Old Contracts"	"New Contracts"	Total Contracts
Opening Balance (1-1-86)	$ 1,000,000	$ -0-	$ 1,000,000
Closing Balance (12-31-86)	$ 2,100,000	$ 900,000	$ 3,000,000

However, in determining the closing balance reserve amount for the "old contracts", the taxpayer had recomputed this balance under a new method and reported the balance as shown above to be $2,100,000. If the closing balance had been computed under the old method (i.e., the method that had been used for the opening balance), then the closing balance for the "old contracts" would be $1,400,000. The difference in this closing balance reserve is $700,000.

Moreover, the examining agent has identified that the closing balance reserve amount for the "new contracts" should be $800,000 resulting from an incorrect actuarial assumption used by the taxpayer in determining this reserve balance. The difference in this closing balance reserve is $100,000.

ASSUMPTION # 1: The difference of $700,000 for the "old contracts" is a change in basis of computing reserves. In addition, the difference of $100,000 for the "new contracts" is an audit adjustment identified by the examining agent as due to a change in actuarial assumptions.

Pursuant to section 807(f)(1), the adjustment methodology would be applied as follows:

> For the "old contracts", the $700,000 difference in the closing balance reserve amount, as a result of a change in basis, will get the 10-year spread adjustment starting in the 1987 taxable year.
>
> For the "new contracts", the $100,000 audit adjustment does not get the 10-year spread treatment; rather, this adjustment is disallowed in full as of the end of the 1986 taxable year, and the closing balance reserve amount for the "new contracts" will be adjusted to $800,000.

ASSUMPTION # 2: All the adjustments to the reserve balances are determined to be a correction of an error, rather than a change in the basis of computing reserves pursuant to section 807(f).

In those situations where section 807(f) does not apply, adjustments to the reserve balances should be made in the year of the error. Under the facts described above, the $ 100,000 adjustment to the closing balance reserves for the "new contracts" is made in full as of the end of the 1986 taxable year. In respect to the $ 700,000 adjustment to the closing balance reserves for the "old contracts", the $700,000 reduction to the closing balance due to the correction of the error arising in 1986 is not subject to the 10-year spread and is also made in full as of the end of the 1986 taxable year.

CRITERIA FOR TREATMENT OF RESERVE ADJUSTMENTS:

The following list provides some examples of those changes in reserve computations that are appropriately classified as changes in basis subject to the provisions of section 807(f). These examples are intended to provide general guidance in a number of typical situations arising in the field, and the list is not intended to be exhaustive:

1. Changes in the assumptions as to when premiums are paid. For example, a company may change from the assumption that premiums are paid annually in advance to the assumption that premiums are paid continuously throughout the policy year. (See Rev. Rul. 94-74, Situation 3.)

2. Changes in the assumptions as to when claims are paid. For example, a company may change from the assumption that death benefit claims are paid at the end of the policy year of death to the assumption that such claims are paid in the middle of the policy year of death. (See Rev. Rul. 94-74, Situation 3.)

3. Changes in the assumptions as to the age (or sex) of the insured. For example, a company may use an assumed age (or sex) rather than the exact age (or sex) (in those situations where the insured's exact age or sex is unclear), and then later change to use the exact age (or correct sex) when precise data becomes available.

4. Changes to (a) a prescribed reserve method, (b) the applicable Federal interest rate, (c) the prevailing State assumed interest rate, and/or (d) the commissioners' prevailing standard table. (See Rev. Rul. 94-74, Situation 2.)

Examples of circumstances where changes in reserve computations arise from inadvertent errors in the computations are:

1. Pure mathematical mistakes (e.g., 2 + 2 = 5).

2. A defect in the computer program for computing reserves (e.g., the program left out one of the actuarial factors required to calculate the reserves).

Consistent with Situation 4 of Rev. Rul. 94-74, such inadvertent errors are limited to nonrecurring errors that affect the determination of the amount of a taxpayer's reserves only for a particular taxable year. (See Rev. Rul. 94-74, Situation 4.)

NOTE: Whether making an adjustment for a change in basis or for a correction of an error, the same standards must be used for adjustments to correct for both over-reserving and under-reserving.